HISTORY OF THE CALIFORNIA CRUDE OIL PRICING ISSUE

State of California and City of Long Beach Suit

In 1975, the State of California and the City of Long Beach pursued litigation against seven major oil companies operating in California. They alleged that these companies had conspired to keep posted prices low and that they had been damaged because their oil revenues depended on posted prices. Historically, posted prices were widely accepted as market value by both producers and refiners as well as by both the State and the Federal Government for royalty purposes. Private royalty owners also typically utilize posted prices to measure market value.

By 1991, six of the companies involved (ARCO, Shell, Chevron, Mobil, Texaco, and Unocal) reached settlements to end court actions alleging undervaluation on State and City leases. While their motives for settling are unclear and issues other than valuation were involved, the companies admitted no wrongdoing. A seventh defendant, Exxon, went to trial and was exonerated. (That decision was appealed. On January 31, 1995, the U.S. District Court for the Central District of California ruled in favor of Exxon in Long Beach I. Another appeal covering a later time period, Long Beach II, is still pending.) Given the length and circumstances of the litigation, it is not clear whether the companies settled as a practical matter to cut off the litigation and associated expenses, whether they felt their potential exposure warranted settlement, or both.

The Minerals Management Service and, under MMS contract authority, the State of California Controller's Office, have conducted routine audits of the same companies' payments on Federal leases in California. The audits addressed a wide variety of issues for periods back to the late 1970's. The auditors did not uncover evidence of the majors wrongfully attempting to undervalue crude oil. The audits accepted posted prices as valid measures of market price.

Nevertheless, in 1986, as the litigation continued, MMS contacted State of California officials and other sources to obtain information to review these specific allegations of improper valuation. After reviewing this information, MMS concluded again that the system of posted prices existing at that time fairly represented market value. Also weighing heavily in MMS' decision not to intervene was the fact that the State and City had been unsuccessful in their antitrust claims in court.

Federal Agency Activity

In a similar timeframe, the General Accounting Office (GAO), Arthur D. Little (under contract with the Internal Revenue Service (IRS)), the Department of Energy, the Justice Department and others conducted similar studies and reviews. Many found that occasionally there were differences between the posted crude prices the majors utilized to pay some producers and the prices of crude oil sold at auction. However, none of the studies contained conclusive evidence of illegal activities. Moreover, because the posted prices were utilized in many arm's-length transactions by parties unaffiliated with those who posted the prices, the IRS and MMS concluded that posted prices appeared to reflect market value and the GAO found no evidence to dispute that conclusion. The Justice Department chose not to pursue an investigation.

In late 1993, the MMS decided to reevaluate the issue in light of the recent settlements. The MMS chose to look initially at the amount of potential underpayments to see if it was worth a major reevaluation. Using unverified data from the plaintiffs' legal counsel and their consultants, coupled with production from federal lands, MMS estimated a theoretical maximum underpayment of about $422 million for 1960-1992. Essentially, MMS simply multiplied volumes of production from Federal leases in California by the State's estimated underpayment figures and the applicable royalty rates. This scoping exercise was the basis for MMS' decision to reevaluate its 1986 conclusion not to pursue this issue further.

Since MMS reviewed the underpayment issue in 1986 and found posted prices contemporaneous with the review to reasonably represent market value, MMS continued its studies in early 1994 by examining the publicly available data for the period 1986-1992. That period was initially evaluated and preliminary conclusions reached in April 1994. Because MMS works closely with the State in auditing mineral revenues in California, that draft report was shared with them. Both MMS and the state agreed MMS should seek additional input from other agencies and should take further measures to gain access to data under court seal that was previously unavailable to MMS before concluding its evaluation.

Interagency Task Force

To reach closure on the undervaluation issue, MMS formed an interagency task force in June 1994, with some of the agencies that had also reviewed the matter previously -- Commerce, Energy, and Justice. The purpose of the task force was to obtain any additional data that would enable a final determination to be made regarding whether the majors wrongfully undervalued crude oil from Federal leases. An important source of information was the court-sealed documents, which had been subpoenaed from companies involved in the Long Beach II litigation as well as ARCO and British Petroleum.

These documents, which reflected activities that occurred between 1980 and 1989, indicated a need for a closer study of crude oil pricing practices. The task force recommended that a special audit be performed to determine if Federal lessees in California received additional consideration that would be subject to royalties.

This proposed special audit differed from conventional audit methods, which relied on posted prices to set value for normal non-arm's-length transactions. The special audit looked beyond posted prices to find any additional portions of gross proceeds which may have been received by a lessee or its affiliate. Previous audits relied on benchmarks based on posted prices as outlined in MMS valuation regulations.

An audit plan was developed by MMS audit staff with input from the California State Controller's Office that included examination of two companies' federal oil production in California for three, one-year periods. The auditors looked beyond posted prices to determine whether undervaluation of crude oil and a pattern of underpayment existed.

While the audits proceeded, team members performed a more detailed review of the court-sealed documents. The team noted that much of the oil in California moves internally within the major oil companies, and that premiums above posted prices often were paid in arms-length transactions. Theses findings confirmed the results of the preliminary MMS audits. After presenting an informational summary to the Assistant Secretary of Land and Minerals Management (AS/LM) and the MMS Director, the team was next asked to provide a list of options for MMS to consider in addressing the royalty undervaluation issue.

In December 1995, the team briefed the AS/LM and the MMS Director on the options they developed, ranging from simply modifying the oil valuation regulations prospectively to valuing past oil royalties in California at a price comparable to that for imported Alaskan North Slope crude oil. On hearing the various options, the AS/LM and MMS Director asked the team to develop a final report including recommendations.

On May 16, 1996, the team delivered the final report to the AS/LM and MMS Director. While team members disagreed on some details in the report, it included a variety of recommendations on:

(1) proposed ways to collect royalty underpayments before and after MMS changed its valuation regulations in 1988,

(2) time period in which to attempt collections,

(3) revisions to the MMS oil valuation regulations, and

(4) a variety of related details.

The AS/LM and MMS Director will make decisions soon regarding the team's recommendations.

Related Matters:

Settlements

MMS occasionally enters into multi-issue royalty settlement agreements with its larger payors, among them companies involved in the California crude oil controversy. These agreements are designed to settle legitimate royalty disputes where reasonable people can disagree. Litigation is a costly and time consuming way to settle complex technical issues. Such agreements often exclude from settlement issues for which MMS or the companies wish to reserve their right to resolve through other means, such as litigation. The State participated with MMS in negotiation of such an agreement with Chevron, and concurred in language to exclude from closure the subject crude oil undervaluation issue for periods after 1980.

These settlements normally resolve one-time, or old issues about which reasonable people disagree on how MMS' rules should be applied. If it is a recurring issue that needs judicial clarification, MMS simply won't settle it. If it is felt a lessee is intentionally underpaying royalty owed to the Federal Government, the DOI can cancel the lease(s) or seek other civil and criminal sanctions. If it is a complex technical issue with considerable litigation risk, a settlement may be in everyone's best interest. MMS approaches these settlements very carefully with all relevant parties represented, including appropriate State representatives.

Statute of Limitations

In regard to the statute of limitations (i.e., whether DOI may pursue claims that are more than 6 years old), the Department is now involved in several lawsuits in which application of the general federal statute of limitations for contract claims is in dispute. The Tenth Circuit Court of Appeals ruled against the companies' position that the Department has only 6 years from the date of an underpayment to seek collection. Instead, the Court found that the 6-year period does not run until MMS completes its audit if the audit is begun within a reasonable time. The Court ruled that beginning an audit more than 6 years after payment was due is <u>per se</u> unreasonable. The Government also maintains that the contract claims statute of limitations does <u>not</u> apply at all in the context of oil and gas royalty collections. The industry claims that it does. The Fifth Circuit Court of Appeals recently ruled in the Department's favor. The plaintiff requested a rehearing, which was recently denied by the Court. The plaintiff may seek review by the United States Supreme Court.

Under other laws, oil and gas lessees are required to keep their records for 6 years. They may dispose of records after that if the Department has not put them on notice to retain them for an ongoing audit.